

# ***California Public Employees’ Retirement System***

*Report to Management for the  
Year Ended June 30, 2005*

November 16, 2005

To the Board of Administration of  
California Public Employees' Retirement System  
Sacramento, California

In planning and performing our audit of the financial statements of the California Public Employees' Retirement System ("CalPERS"), a component unit of the State of California, for the year ended June 30, 2005 (on which we have issued our report dated November 16, 2005), we developed the following recommendations concerning certain matters related to the System's internal control, accounting, administrative, and operations. Our comments, arranged by Fund, are presented in the exhibit.

This report is intended solely for the information and use of the Board of Administration, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

We will be pleased to discuss these comments with you and, if desired, to assist you in implementing any of the suggestions.

Yours truly,

**EXHIBIT****OTHER ACCOUNTING, ADMINISTRATIVE, AND OPERATING  
MATTERS****California Public Employees' Retirement System  
Year Ended June 30, 2005****PUBLIC EMPLOYEES' RETIREMENT FUND****Reconciliation of CalPERS' Real Estate Contribution and Distribution Control  
Accounts**

**Observation**—As of June 30, 2005, Investment Accounting was not able to provide detailed support to substantiate the balances in the Real Estate Contribution Control and Real Estate Distribution Control Accounts in CalPERS' general ledger. These two clearing accounts are intended to match cash transactions separately recorded by State Street and by the real estate partners. The sources of the amounts recorded in CalPERS' general ledger are State Street and the real estate partners' monthly financial statements. Balances in these accounts typically are the result of temporary timing differences between State Street real estate cash transactions and the monthly financial statements received from the individual real estate partners. As reconciliations are one of the most important components of internal controls, it is important that all activity in these accounts be specifically identified and reconciled on a timely basis.

**Recommendation**—Investment Accounting should establish a standard, repeatable, auditable, and meaningful process for capturing information in the real estate control accounts and reconciling the balances on a monthly basis. To accomplish this, it is necessary to identify all uncleared transactions in these account balances at the end of each accounting period. The sum of the identified uncleared transactions should equal the General Ledger account balance.

**Investment Accounting General Ledger Support**

**Observation**—Fiscal Services does not use the investment accounting general ledger accounts to directly produce the annual financial statements. Rather, Investment Accounting performs a reconciliation from the general ledger to present the investment data for financial reporting purposes. This reconciliation is performed outside of Peoplesoft and contains significant reclassifying adjustments from the general ledger amounts. Additionally, as these adjustments are not posted in Peoplesoft, they are not reviewed by Investment Accounting management as part of the year-end closing and review process. As a result, the investment account balances in the general ledger do not agree to the amounts recorded in the annual financial statements.

**Recommendation**—CalPERS' Peoplesoft general ledger system should directly produce and support the financial statements. The Investment Accounting general ledger should agree to the accounts and amounts used for financial reporting purposes. All reclassification entries should be approved by management and posted to the general ledger prior to generating the financial statements. Any reconciliations between the general ledger and the financial statements should be small in amount and subject to management review.

## OTHER PENSION TRUST FUNDS—IRC 457 Plan

### Reconciliation Process

**Observation**—During our 2005 audit, we identified significant differences between the recorded general ledger balances (i.e. transfers in, transfers out, and participant withdrawals) and the amounts provided by CalPERS' program division. The amounts recorded in the general ledger are based on the State Street monthly statements, whereas the detailed schedules from the program division are generated by and agreed to information provided by CitiStreet, the fund's record keeper. These differences were partially due to a one day delay in posting transactions between State Street and CitiStreet. For example, transactions occurring on the last day of the month are recorded by CitiStreet on that same day, however the transactions are not recorded by State Street until the subsequent day. As such, activity occurring on June 30, 2005, was not recorded by State Street until July 1, 2005, and thus was not reflected in the June 2005 general ledger.

We also noted that the difference between State Street and Citistreet was attributed to incomplete reconciliations that were not consistently prepared on a monthly basis. As the reconciliations were not completed, we identified keying mistakes and other errors that required corrections. These reconciliations had not been reviewed by management in accordance with CalPERS' policy.

As a result of these findings, several audit adjustments were made to the IRC 457 Plan to true up the fund's portfolio activity (including transfers in, transfers out, participant withdrawals, member contributions, investment income, other receivables, accrued liabilities and investments) and properly record the current year transactions as of June 30, 2005.

**Recommendation**—To ensure that errors are identified and reconciling items are resolved timely, reconciliations between State Street and CitiStreet should be performed monthly and completed on a timely basis. Any variances between State Street and Citistreet should be investigated, documented, and resolved. Additionally, recurring adjustments should be recorded to recognize the one day delay in posting activity between State Street and Citistreet. This reconciliation process should be assigned both a primary and secondary preparer and be reviewed and analyzed by management on a monthly basis.

## PROPRIETARY FUNDS—CONTINGENCY RESERVE FUND

### Application of Payments for Receivables From Public Agencies

**Observation**—Invoices are sent to public agencies on the 15th of the month prior to the coverage period (for example, invoices for June 2005 were sent on May 15). These invoices include premiums charges for both employers and employees. Amounts are due from the public agencies by the 10th of the coverage month. The payments received by Contingency Reserve Fund are applied against the outstanding receivable balance rather than to a specifically identified invoice. During each billing cycle, any remaining receivables are closed and then carried forward as an opening balance in the current month's billings. In addition, Contingency Reserve Fund does not have a receivables aging report to track the delinquencies and to analyze the age of an outstanding balance.

**Recommendation**—To ensure that payments are applied to the correct invoice billing cycle and that the aging of outstanding receivable balances are consistently monitored, Health Services should establish a standard method of applying payments to the specifically identified invoice, tracking unpaid balances, and recording an appropriate reserve if the balance is not collected timely. Aging reports should be generated on a periodic basis to monitor outstanding balances.

## PROPRIETARY FUNDS—LONG TERM CARE FUND

### Enhancements to Actuarial Valuation

**Observation**—The actuarial valuation for the Long-Term Care program was performed by United Health Actuarial Services for the 2004/2005 fiscal year. The previous valuations performed by Tillinghast included cash flow testing projections to assess the adequacy of the assets supporting the liabilities related to potential future new-money investment earnings scenarios. The current valuation does not include such an assessment.

**Recommendation**—CalPERS should include cash flow testing projections as part of the annual Long Term Care Fund actuarial valuation. Cash flow testing is required by state regulators for most LTC insurance programs and can be an integral part of the valuation process. Because LTC involves such long duration coverage, it is important that the assets be appropriately matched to the liabilities they are backing. Various future economic scenarios to project have been prescribed by the regulators, and certain criteria must be met in order to “pass” the cash flow tests. Failed tests can indicate the need to strengthen reserves.

While this does not directly impact the reasonableness of the current LTC program valuation from an audit perspective, we recommend that CalPERS reinstitute cash flow testing for valuations in future years as an additional assessment tool for determining the financial balance of the LTC program.

### OTHER OBSERVATIONS AFFECTING ALL FUNDS

#### Recording of Transactions Outside the General Ledger

**Observation**—Certain of CalPERS’ funds maintain monthly transaction activity in Excel spreadsheets. These spreadsheets are the sole support for the activity. CalPERS maintains an internal control structure over its Peoplesoft general ledger system. However, this internal control structure does not include Excel as end-user applications are not subject to normal information technology controls such as change controls, version controls or regular backups. Additionally, Excel is not supported by CalPERS’ Information Technology Services Branch, reducing its reliability.

**Recommendation**—End-user applications (such as Excel) do not receive enterprise information technology support or use the same controls as the Peoplesoft financial accounting system. Peoplesoft is subject to important information system controls that is supported by CalPERS’ IT department. Peoplesoft maintains sufficient capabilities to track all general ledger transactions and produce financial statements meeting CalPERS’ requirements. Fiscal Services should avoid user-created spreadsheets to support the amounts in the financial statements as all activity should be posted directly to the Peoplesoft general ledger system.

#### Posting Journal Entries in Aggregate

**Observation**—Fiscal services and investment accounting post certain journal entries in the aggregate (such as on a monthly or quarterly basis). Posting journal entries in aggregate does not provide an adequate audit trail to investigate the underlying transactions or research historical activity. Additionally, posting journal entries in aggregate increases the probability of user mispostings or mistakes.

**Recommendation**—Journal entries should be separately posted for each identifiable accounting transaction. Appropriate support should be maintained for each posted activity. This will create an effective audit trail, facilitate research and investigation, and decrease the likelihood of user errors.

## **GASB 40 Disclosures**

**Observation**—The June 30, 2005, fiscal year-end was the first year CalPERS implemented the new GASB 40 disclosures for the Fund's investments. Fiscal Services used queries developed by State Street to assist in the disclosures. However, certain of the queries did not include the entire pool of investments held by CalPERS. For these queries, Fiscal Services had to estimate the disclosure information for investments excluded by the queries.

**Recommendation**—CalPERS should work with State Street to ensure that all applicable investment information and amounts are extracted for financial reporting purposes. Reports from State Street Bank should include all investments held by CalPERS. These reports should be reviewed by fiscal services and investment accounting management to determine the reasonableness and accuracy of the amounts.

## **Monitoring of Actuarial Assumptions**

**Observation**—The Actuarial and Employer Services group recommended that the CalPERS Board adopt an employer rate stabilization policy to reduce the volatility of employer contribution rates. The recommended changes would be effective for the employer contribution rates for fiscal 2005-2006 for State and School plans and fiscal 2006-2007 for public agency plans.

The employer rate stabilization policy introduced the following three changes:

- Developing the Actuarial Value of Assets (AVA) by smoothing 15 years of asset gains and losses, with the result limited to within a corridor of 80%-120% of the market value. The old method uses three-year smoothing, with the result not to be outside a 90%-110% corridor. The corridor change was developed in relation to the change in the asset smoothing method. The use of this specific corridor is very common for pension plans
- Calculating the annual contribution amount with a rolling 30-year amortization of the gains and losses ("combine and offset"). The old method is based on a 10% amortization of the gains and losses
- Imposing a minimum employer contribution rate equal to the employer normal cost minus a 30-year amortization of surplus.

In terms of smoothing of assets, GASB 27 refers to Actuarial Standard of Practice Number 4 (ASOP 4), which in turn describes recommended standards for asset valuation and smoothing methods. The asset valuation method used by CalPERS produces substantially greater smoothing of asset values than is the norm for public pension plans. In the "Public Fund Survey for FY 2004 prepared by the National Association of State Retirement Administrators in September 2005, only 6% of 127 public pension plan surveyed used a smoothing method greater than 8 years (CalPERS was included in the 6%).

**Recommendation**—Due to the significant changes in the actuarial assumptions and methodologies, we recommend that AESD closely monitor the new approach to ensure that it provides reasonable results.

## Information Security—Novell Administrators

**Observation**—Novell currently has 38 users with administrative access in the system with the ability to grant and revoke privileges to specified directories in Novell. We noted that some of these users were given administrative access to manage storage capacity when needed. However, administrative rights are not required to perform this function.

**Recommendation**—Novell administrators have the ability to alter network parameters, which changes the manner in which the system operates. Administrators can grant, revoke or alter user access privileges, which can give users access to system functions outside of their normal usage. This could potentially shut down or delete data from the network rendering it ineffective and resulting in financial and/or operational damage, loss of system, or improper use of resources.

We recommend that CalPERS IT management review the current list of Novell Administrative users and revoke access to those who do not require it to perform their job functions.

## Information Security—Physical Access to Computer Rooms

**Observation**—In conjunction with our information security testing, we selected a sample of 10 employees with access to the computer rooms as of June 2005. From our sample of 10 users, we identified one user who was granted access to the computer room, although this access was not specified in the corresponding Access Request Form. In addition, there are currently 165 non Colliers employees who have access to the computer rooms, of which 146 are from ITSD. Frequent reviews of users with access to the computer room are currently not performed by CalPERS.

**Recommendation**—Inappropriate access to the computer rooms creates the risk of unintentional or intentional damage to information resources, including computer hardware, data storage media, and information systems documentation. If physical information resources are not adequately safeguarded, such resources may not be available when they are needed and/or recovery of such resources may be delayed in the event of an emergency.

We recommend that access to the computer rooms be granted only to IT staff requiring it as part of their job function. In addition, IT management should perform periodic reviews of employees with access to the computer rooms to determine if access is still appropriate.